Seed Weekly

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seed investments

COVID-19 Revelations – A Substantially Overgeared Financial System

The Covid-19 Shutdown Has Revealed Some Cracks

The global shutdown to economies in order to try and reduce the spread of the coronavirus has, and will continue to, impact both personal and business incomes. But this has also been severely exacerbated by the financial strain of too much debt in the system.

How come, therefore, in a world that is (supposedly) drowning in savings (hence, the low interest rates, right?) is there just so much debt?

Let's start at the beginning.

1) Debt and Credit

The word *"credit"* originates from Latin credere which is *"to trust, entrust, believe."*

The opposite side of credit is debt (i.e. someone or some entity has sufficient trust or belief to advance a loan in the form of **credit,** which for the person or entity receiving - the borrower - becomes a **debt obligation**).

The credit advanced allows for the consumption of goods and services, or the investment into capital goods to produce consumption goods. So, instead of the borrower having to save, by taking on debt he has immediate funds in order to deploy into consumption and capital goods.

It's A Win-Win Situation

The lender receives interest on the funds lent out, generating a return on his capital, while the borrower has immediate access to capital to deploy. If the borrower invests this loan into projects that generate a higher return than the cost of his total borrowings, then he also generates a net positive return on his investment.

It is such a fabulous scenario for all parties involved that the total quantum of debt in the world was last estimated by the Institute of International Finance (IIF) to grow to some $257 trillion at the end of March. This is money owed by all parties in the economy – households, governments, financial and non-financial corporates.

But, if both parties win in good times, both parties can also lose when *"bad"* times hit.

Because the substantial bulk of debt obligations comes not from accumulated savings, but from central bank money creation multiplied through the banking system, it stands to reason that in a time of crisis both lenders and borrowers turn back to the central banks of the world and beg, *"Please Ma'am, can I have some more?".*

Is it right that our financial system continues to look to central banks and governments to bail us out of this predicament?

This bailout is colloquially known as the **"Fed put"** (i.e. in times of market stress and in increasing doses, the central bank systems of the world will continue to come to the rescue). They do this by :

- Reducing and keeping interest rates much lower than the natural rate would demand, and -
- Increasing the money supply and injecting this through the banking system.

Tuesday's surge in prices of over 11% for the Dow Jones Industrial Index (its best single day since 1933 after Washington announced a $2 trillion stimulus package) indicates just how addicted market prices are to fresh doses of new money.

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2) Which Leads Us To The Difference Between Keynesian and Austrian Economics

The global financial system is therefore, at its core, **Keynesian** – named after British economist John Maynard Keynes. It is not only the predominant belief system, but the methodology that virtually all governments have now adopted as mainstream economic theory.

Contrast this with **Austrian economics**, which is definitely the minority view.

So, what are the fundamental differences and why should we even care at this stage, when the world is far more concerned about the Corona Virus?

Keynes's view was that in order to smooth out the normal business cycles and to avoid any hard landings, governments can play a crucial role as an intermediary when business cycles turn down. They can do this through two main tools :

- Monetary policy (controlling money supply and the key interest rates), and –
- Fiscal policy (the tax take and running surpluses or deficits).

Academically the notion is sound. Business cycles turn down – caused by too much supply or too little demand – which, in turn, leads to unemployment. Keynesian thought says, "No Problem". Governments can cut interest rates and inject more funds into the banking system, making it easier for constrained consumers and businesses to borrow and spend.

And voila – the economy turns back up and off we go again!

The underlying belief is that markets are not always efficient, and so government is there to intervene and lend a helping hand. The problem is always turning this off when the cycle picks up again.

Austrian economics originated in early 20th Century with the work of Austrian Carl Menger, and expounded upon by many others, including Friedrich Hayek and Ludwig Von Mises. The belief is that the private sector is best at working through supply and demand imbalances without external intervention from government, which typically causes distortions. Their theory is that in a normally functioning capitalistic economy, imbalances will quickly be reflected in prices, which in turn will provide the necessary signals that will ultimately shift supply and demand to where it needs to be. Intervention can only result in unintended consequences.

There are some variations to these and other more extreme economic theories, including **Monetarism** (a slow and predictable increase in money supply to ensure price stability), **trickle-down economics** (deregulation and cutting of corporate taxes, which will trickle down to the man in the street) and now **Modern Monetary Theory (MMT),** which can be best described as Keynesian economic theory on steroids.

Some of the arguments that Austrian theory have against Keynesian theory include:

Artificially Low Interest Rates Have Consequences

One of the foundational theories of Austrian economic thinking on the business cycle is that banks' excessive issuance of credit at artificially low interest rates ultimately results in *"malinvestment"* by businesses.

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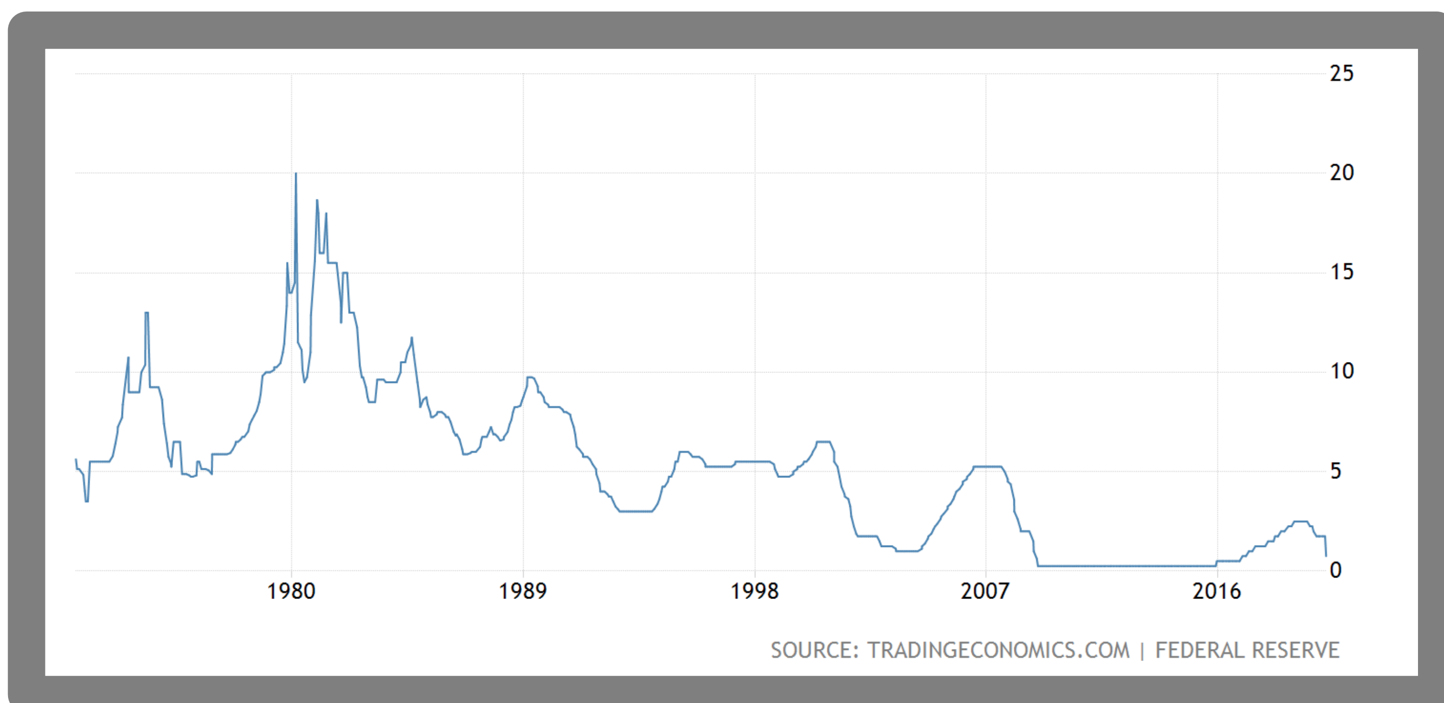
Suppressing Volatility Through Lower and Lower Interest Rates Contributes to An Increase In Volatility In The Future

Low levels of volatility have often been followed by bursts of extreme high volatility, again exacerbated by high debt levels.

The chart below is the short-term Fed funds rate which, since being pushed up dramatically into the late 1970's to curtail high inflation, has trended down back to the current 0% level. Austrian economists believe that the rate has typically been set too low.

Chart 1 : US Effective Federal Funds Rate



3) History of Accumulated Debt

As mentioned, the estimated total value of all outstanding debt in the world will approximate some $257 trillion by the end of the first quarter of 2020, and this was before the latest rounds of new debt issuance by central banks following the Corona Virus shutdown.

This debt is owed by a number of parties. There are numerous ways to slice and dice the data, but one way is to define the four main parties that are indebted as governments, non-financial corporates, financials and households.

Debt is originated through the banking system in what is known as fractional reserve banking. This refers to the fraction of deposits that are held in reserves and varies in percentage terms from 0% to around 10% depending on the size of banks and from central bank regulation from time to time. Essentially what that allows is for savings held in the banking system to be multiplied out many times over in the forms of advances.

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Central banks, and specifically the US Federal Reserve as custodian of the world's reserve currency (the US Dollar), have been instrumental in this process of multiplying relatively small levels of savings through the banking system, into debt levels orders of magnitude higher.

With a mandate of price stability, central banks have increased money supply and retained interest rates at artificially too low a level, in order to induce an ongoing credit expansion.

Period from Mid 1940's to Mid 1970's

From the time that the US Dollar ascended to the level of world's reserve currency at the Bretton Woods Conference in July 1944, until around the mid 1970's, the world's financial system was largely stable.

In no small part was this due to the fact that the Bretton Wood's Agreement essentially tied major world currencies at pegged exchange rates to the US Dollar, and the US Dollar, in turn, to gold. One ounce of gold was not only pegged at USD 35, but the US would convert dollars to gold at that rate. The US held the dominant power as WWII was coming to an end, while Britain and its financial position had been dealt a major blow.

By linking the US dollar to gold, where the US held the dominant share of world reserves, debt levels to GDP and foreign exchange currency levels relative to one another were kept in a relatively stable band.

Period from Mid 1970's to current

From the late 1960's and into the 1970's, the US came under increasing pressure to move away from the original Bretton Wood's Agreement, due to US trade deficits and debt and fiscal pressures resulting from the Vietnam War. Foreign central banks, increasingly concerned about the financial position of the US, started demanding gold at the agreed USD 35/oz rate. However, as this led to foreigners shipping their US Dollars back and gold moving out of the US, by August 1971 Nixon was forced to end the dollar convertibility to the gold peg.

This was essentially a form of default by the US government on its debt obligations. By painting itself in a corner where it could no longer settle its growing foreign obligations in gold, it *"defaulted"* by devaluing the US overnight to the previous peg of USD35/oz. In less than 10 years, the dollar depreciated to over USD 850/oz.

From that period onwards the US, and consequently the rest of the world, experienced major financial bubbles - each one bigger than the last.

4) Examples of Financial Debt Bubbles

- Late 1970's – Latin American foreign debt crisis
- Late 1980's to early 1991 – Japan asset price bubble
- 1997 Asian financial crisis
- 1998 Russian financial crisis
- 2000 dot com bubble
- 2007 – 2010 subprime mortgage crisis
- 2012 – 2015 European sovereign debt crisis

The one and only response from central banks – but in a more and more desperate attempt is to create more liquidity and inject this into the banking system. In the US, this is achieved by the Fed creating money (on their computer system) and with this newly *"created"* money, buying government bonds issued by the US Treasury. In this latest round they are also buying mortgages and corporate credit to ensure that the pyramid of debt does not come crashing down.

5) So Then Why Is the US Dollar So Strong

Against this backdrop of trillions of dollars of money creation, investors have expected two main adverse consequences. Firstly, inflation and secondly a weak US dollar.

They have proven to be wrong in terms of the US dollar and somewhat wrong with respect to inflation. The world has seen very little consumer price inflation, but what we have seen is global asset price inflation as money creation has found its way into asset prices.

The US dollar has been very strong across multiple currencies and the main reason for this is the quantum of dollar denominated debt relative to the availability of actual dollars to service the interest and capital repayments of that debt. The greater the shortage of actual dollars required to service the growing quantum of debt, the greater the squeeze on the US dollar.

In times of stress when obligations on debt become due, and over leveraged borrowers receive margin calls as asset prices backing their debts decline in value, the demand for US Dollars increases.

Conclusion

So, who are the winners and losers in a debt based financial system?

The current debt-based system based on interest rates that have been suppressed to artificially low levels and ever-increasing levels of debt, does NOT favour those that try and save by keeping their funds largely in interest bearing accounts.

This system has definitely favoured those investors that have been able to **a)** take advantage of the low interest rates by gearing up, and **b)** buying various assets such as shares in companies (either in listed or unlisted form and fixed property).

In times of stress, as we are seeing now, the high debt levels can quickly turn into a disadvantage, however, nullified time and again by central banks coming to their rescue.

This distortion in the financial system has allowed for the rich to become richer and the poor to become poorer over the last few decades. The US Dollar, as the world's reserve currency, has also served the US well to the detriment of most other countries.

It is understandable, therefore, that after a long period of taking on too much debt that there needs to be a time of purging. This current cycle of deleveraging does, however, cause pain for owners of assets.

Because central bankers are all Keynesian at heart, we know that they will continue to come to our rescue. What we (and they) don't know, however, is just when they tip the whole system over the edge. For this reason, it is becoming increasingly

important to establish an investment policy that takes advantage of risk assets, but also ensures capital protection in times of stress.

As always, and especially in these more troubling times, please do not hesitate to contact any one of the team or myself. Our business will continue uninterrupted for the duration of the lockdown and each member of the Seed Team is set up and resourced to work remotely. Our team remains committed to supporting you on your financial journey, and we are available to answer any questions that you may have.

Please feel welcome to phone us on +27 21 914 4966 or send an email to info@seedinvestments.co.za (general enquiries) or wealthadmin@seedinvestments.co.za (private client assistance).

Kind regards,

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